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Rising Informality

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Reversing the Tide

By some estimates more than 30 percent of the developing world's GDP and 70 percent of its workers are outside the official economy. The implications: Most small firms are trapped in low-productivity operations with little access to finance, key government services, and formal customers. Workers lack safety and social protection. And bigger, better-connected firms use "unfair" informal practices to beat out more productive formal competitors. The result is slower economic growth and a growing social divide between the informal and formal parts of society.

Informality is a common term for the output and workforce of firms not registered with the government as well as the unreported activities and workforce of registered firms. Thus by definition the size of informal activity is difficult to estimate. But the various methods devised to "measure" informality, while yielding somewhat different estimates, all show that informality is big and growing rapidly, especially in the poorest developing countries.

An authoritative measure—developed by Friedrich Schneider, a professor at the University of Linz, by synthesizing the methods and estimates of other analysts—shows that informality accounted for more than 30 percent of all economic activity in the developing world in 2003 (Schneider and Klinglmair 2004). The picture in employment is even worse: the International Labour Organization (2002b) estimates that more than 70 percent of the workforce in the developing world is informal (this larger percentage reflects the fact that informal activities are less than half as productive as formal ones).

The Russian Federation and countries in Sub-Saharan Africa, Latin America, and Central Asia have the highest levels of informality, often more than 50 percent of GDP. They have also seen the greatest increase in informality since 1990. Informality also is growing fast in South Asia and the Middle East and North Africa, though from relatively low levels. By contrast, in Central Europe the growth of informality is slowing in the wake of extensive microeconomic reforms, while in East Asia, where firms face smaller regulatory and tax burdens, informality remains stable at fairly low levels (around 20 percent of GDP). In the

industrial world informality accounts for less than 15 percent of GDP (figure 1).

Root causes

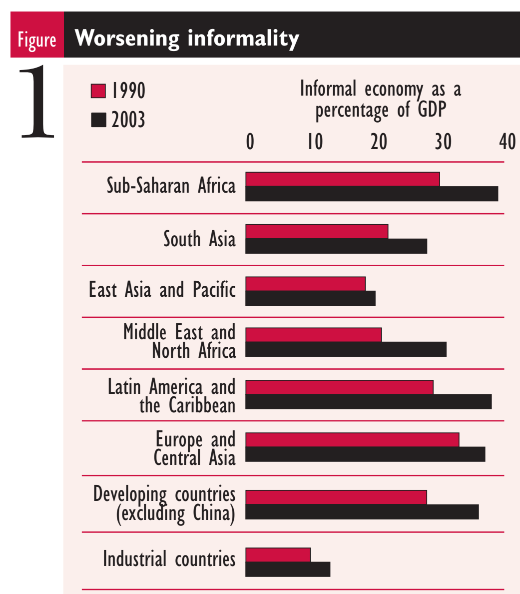
What are the root causes of informality? Overly stringent and expensive government regulations in the labor, product, and land markets, and an ever increasing tax burden imposed on an ever shrinking formal sector.

Labor informality

Informal workers in developing countries have few social rights, with no social security, severance pay, minimum wage, or standards for working conditions. Moreover, they receive little vocational training. Housing developers, for example, commonly rely on labor contractors providing very cheap informal labor and thus have few means and little incentive to train their volatile workforce. For the economy, the result is low productivity.

Ironically, labor informality is largely a consequence of labor laws and regulations whose very aim is to provide workers with protections and benefits. Why the perverse results? The laws and regulations tend to be either poorly designed or too generous given the enforcement and financial capacity of most developing countries. As the World Bank's Doing Business project has shown, for example, hiring and firing regulations designed to protect workers have instead discouraged firms from hiring formal employees—because compliance is so cumbersome and expensive (World Bank 2004).

Figure 1 Worsening informality



Source: World Bank 2004.

Product informality

Informal firms beat formal ones through product informality. A large share of products and services in the developing world are informal, because they fail to comply with product market regulations or have been produced by unregistered or unlicensed firms. Indeed, cumbersome and expensive business registration procedures are among the most talked about sources of informality. Industry-specific licensing restrictions are even more damaging. Developing countries often have hundreds of such licensing regimes, covering the entire range of economic activities.

The food sector shows how overly stringent regulations—in this case health standards on food products—end up doing more harm than good, just as in the labor market. Consider the Arab Republic of Egypt, which continues to impose obsolete quality standards (rather than minimal health standards) on food products, with the result that more than 80 percent of its food is produced by informal, small-scale, low-productivity providers. Indeed, most food consumed in the developing world evades all health regulations.

Product informality also results from poor enforcement of intellectual property rights and lack of consumer information. Substandard counterfeit products, increasingly widespread, can cause serious health hazards (such as through outdated medicines) or reduce productivity (through diluted fertilizers). Trade barriers are another source of informality, leading to informal trade that puts formal manufacturers and retailers, which cannot risk relying on smuggled goods, at a serious disadvantage. In the utility sector subsidized prices or government monopolies lead to informality, by discouraging or preventing formal private investment. Thus in Mumbai the inhabitants of slums must cope with substandard and expensive water provided by informal water distributors—even as the rich residents of downtown penthouses enjoy almost free water provided by the state-owned monopoly.

Land informality

In the land market the root causes of informality are unsecured and expensive land registration processes (see World Bank 2004), government ownership of land, low property taxes, and subsidized utility prices that make developing new land a losing proposition for governments. As a result of all this, the supply of formally developed land in developing country cities has not kept pace with growth in the working-age population and migration from rural areas—and the price is often on a par with that in rich country counterparts. This situation leads to nearly half the urban population in the developing world living in slums.

But the economic cost of informal land is also high. Companies operating on informal land have no access to mortgage-backed financing, which even in the United States remains the main source of long-term financing for small and medium-size enterprises. In addition, land informality distorts competition in such key industries as retail and housing construction as "land mafias" use their connections to obtain informal land in prime locations at very low prices (as housing developers and operators of open-air markets do in Russia, for example).

Tax evasion

Avoiding taxes is a key motivation for being informal. Industry studies in developing countries by the McKinsey Global Institute point to tax evasion as among the main reasons for persistent low productivity in most large domestic sectors, such as retail, food processing, and housing construction.[1] A vicious cycle is at work: tax evasion by informal operators takes away the productivity advantage of large formal firms, leading to more informality—and forcing governments to collect more and more taxes from an ever shrinking formal sector.

Industrial countries never had this problem, because they managed to avoid imposing a big tax burden on companies. France and the United States in 1913—at the same level of economic development as Brazil today—collected less than 10 percent of GDP in overall taxes, compared with more than 30 percent for Brazil today. The few developing economies that became rich in the 20th century (such as Japan, the Republic of Korea, Singapore, and Taiwan, China) similarly avoided imposing a big tax burden, by keeping public spending under control even while providing outstanding infrastructure, education, and health care.

Reversing the rising tide of informality

Fighting informality calls for a major simplification of labor, product, land, and tax regulations along with privatization and drastic improvement of governance in the public sector.

- *Reducing the stock and flow of regulations and procedures.* Every country should conduct a systematic inventory of its rules and regulations to eliminate all those that cannot be justified. An independent body of professionals should carry out this review (with participation from the private sector)—and should also review any new regulatory proposals. The McKinsey studies show that tackling product market regulatory issues (entry and trade barriers, product standards, pricing regulations) will have the greatest benefits. These issues also are relatively easy to deal with, at least from a technical standpoint.
- *Reducing and simplifying taxes and import tariffs.* Governments always raise the specter of falling revenues as justification for imposing new or higher taxes—but in fact reducing and simplifying taxes and import tariffs often increases revenues by encouraging business activities and reducing the incentive for tax evasion. If it does not, in some developing countries donors could make up the difference until unnecessary public spending is cut or new or better taxes (such as land property taxes) are put into place.
- *Increasing the stock of formal land.* Many land reform attempts are mired in small-scale land titling programs. A better way to start is to make government land available for private development (developing country governments own a lot of unused land) and to privatize utilities (or at least allow public-private partnerships in new projects). This strategy would have the double advantage of generating the funds needed to develop infrastructure while lowering the price of formal land. Relaxing tenant laws, zoning restrictions, and building codes is also a relatively quick and easy way to increase the availability of formal

land. Finally, rates of land property taxes (relatively easy to enforce equally) should be increased to discourage speculators from holding vacant land and to provide local governments with the financial means and incentive to develop more land for commercial and residential use.

- *Improving access to credit.* Since access to affordable finance is among the main incentives for companies to become formal, governments should make lending to small companies much more attractive to banks—such as by strengthening creditor rights, enabling secured lending (with both land and movable assets as collateral), and raising interest rate ceilings. New evidence from the Consultative Group to Assist the Poor, showing that private banks under competitive pressure are much more likely to devise innovative ways to serve small businesses profitably, suggests that governments also should privatize banks and reduce licensing requirements on financial institutions to ease entry (CGAP and World Bank Financial Sector Network 2004).
- *Improving public sector governance.* By reducing the scope for government interference in the economy, all these reforms should help weaken the impact of poor governance and focus scarce enforcement capacity on the main offenders. But it is also critical to improve governance. Increasing transparency and accountability would encourage companies to join the formal economy (promoting e-government solutions that are easily replicated and scaled up is one way to help in this). Improving government services such as the police and judiciary would provide another strong incentive to do so.

Forceful action along these five fronts is the only way to transform the vicious cycle of informality into a virtuous one of formality—as more and more companies find that the benefits of joining the formal economy exceed its costs.

Note

1. See reports for Brazil (1998), Russia (1999), India (2001), and Turkey (2003), available at http://www.mckinsey.com/mgi.

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